

SUMMARY ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Runner Analyst: Norm Catelli Bill Number: AB 240

Related Bills: See Legislative History Telephone: 845-5117 Amended Date: April 17, 2001

Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: MIC/Increase To 7% & Extend To Mineral Extraction & Electric Power Generation/Delete Repeal

DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _____.

X AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

X AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended February 14, 2001.

X FURTHER AMENDMENTS NECESSARY.

DEPARTMENT POSITION CHANGED TO _____.

X REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED/AMENDED February 14, 2001 STILL APPLIES.

X OTHER - See comments below.

SUMMARY

This bill would:

- increase the Manufacturers' Investment Credit (MIC) from 6% to 7% of the cost of property used in manufacturing and certain other specified activities,
- extend the credit to certain electric power generation businesses,
- extend the credit to certain mineral extraction businesses,
- restructure the definition of qualified property with respect to property used in research and development,
- expand the definition of capitalized labor costs,
- allow the credit to reduce the alternative minimum tax for corporations, and
- extend the credit indefinitely.

SUMMARY OF AMENDMENTS

The April 17th amendments would provide an expanded definition of qualified property used in research and development to include research conducted by not only a qualified taxpayer, but also by a member of the qualified taxpayer's unitary group. The amendments also would expand the definition of capitalized labor costs eligible for the credit to include certain indirect costs in addition to direct costs. In addition, the amendments allow the credit to reduce the alternative minimum tax for corporations.

Board Position:

<u> </u> S	<u> </u> NA	<u> </u> NP
<u> </u> SA	<u> </u> O	<u> </u> NAR
<u> </u> N	<u> </u> OUA	<u> X </u> PENDING

Legislative Director

Date

Brian Putler

05/01/01

The departments unresolved implementation, technical, and policy concerns, as well as the new technical and policy concerns arising from the amendment and the new revenue estimate, are provided below.

Except for the discussion in the analysis, the department's analysis of the bill as introduced February 14, 2001, still applies.

POSITION

Pending.

Summary of Suggested Amendments

Amendments are needed to clarify how extractive activities fit into the activities contained in the definition of qualified property. See "Implementation Considerations" below. Department staff is available to assist the author with amendments. Amendments are provided to resolve the "Technical Considerations" discussed below.

ANALYSIS

IMPLEMENTATION CONSIDERATIONS

Under current law, the definition of qualified property includes tangible personal property used for specified activities, beginning with the point raw materials are introduced to the process and *ending at the point the activity has altered tangible personal property to its completed form, including packaging, if required*. This bill would add "extracting" to the list of activities that define the end of the "process." However, it is unclear whether extractive activities result in the altering of tangible personal property to its completed form. Thus, the definition of qualified property may not properly address extractive activities. This could result in some extractive industry taxpayers not being entitled to the MIC as intended by this bill. This could result in disputes between taxpayers and the department.

TECHNICAL CONSIDERATIONS

This bill would remove the repeal date from the credit. However, two references to the sunset date remain in the credit. Amendments are provided to remove the references.

This bill adds an expanded definition of tangible personal property. However, the reference to Internal Revenue Code (IRC) Section 1245(A) should be IRC Section 1245(a). Amendments are provided to resolve this issue.

ECONOMIC IMPACT

Revenue Estimate

Based on the discussion below, the revenue loss from this proposal is as follows:

Revenue Impact of AB240 For Taxable Years Beginning On Or After January 1, 2001 Assumed Enactment After June 30, 2001 (In Millions)		
2001-2	2002-3	2003-4
-\$135	-\$165	-\$170

Eliminating the repeal date from the MIC would not impact current revenues. It is anticipated that the MIC would not sunset under the current law requirement.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

This estimate is based on data from a U.S. Census Bureau survey of capital expenditures by relevant industries for 1997 and 1998, micro simulation models of California tax returns for tax years 1997 and 1998, and other departmental data. These numbers were grown to approximate 2001 and beyond. The credit use rates taken from the models were then applied to derive the aggregate credit use. The fiscal year cash flow patterns are based on the department's analysis of how manufacturers adjusted their tax payments to reflect the reduction in liability resulting from the current law MIC.

This estimate does not include losses resulting from qualified taxpayers, as defined under current law, that might receive additional credit for activities that would qualify under the changes made by this bill. Such losses cannot be quantified since the data and information needed are not available.

ARGUMENTS/POLICY CONCERNS

This bill would benefit transactions for which binding contracts already exist and would not be limited to benefit only future business decisions. Contracts entered into after January 1, 1994, but prior to enactment of this bill, already qualify for the credit. Existing binding contracts that require the payment of otherwise qualified costs under the MIC would qualify for the increased MIC benefit (additional 1%) provided under this bill.

The bill would amend the qualified activity definition within the qualified property definition by expanding the "process" (manufacturing, processing, refining, etc.) to include "the point at which any raw materials are obtained." Because this change is not limited to the extractive activities added by this bill, it would allow existing qualified taxpayers to claim the MIC for equipment used to transport raw materials from the point that they are obtained (for example, a warehouse owned by the taxpayer) to the actual manufacturing, fabricating, etc., site. Under current law, such equipment would not qualify for the MIC because the MIC is limited to equipment use beginning at the point where raw materials are "received by the qualified taxpayer and introduced into the process."

Further, if the term "obtained" were construed to mean the point at which title transfers, then a taxpayer that transported raw materials by trucks that it owned or leased, regardless of distance, might be entitled to claim the MIC for the costs of the trucks. Under current law, the trucks would not qualify since they would not be treated as equipment used in the "process" qualifying the taxpayer for the MIC. Instead, under current law, they would be used either to transport the raw materials to the manufacturing site or to transport the finished product to the retailer or ultimate consumer, neither of which would qualify for the MIC.

Allowing the research and development activities of one member of a unitary group to affect the taxation of another member is a divergence from the concept of unitary reporting, i.e., each entity maintains its separate existence and is responsible for its own taxes. Further, it would expand the class of taxpayers eligible for the MIC since it would allow research and development affiliates who might properly be classified under SIC Code 8731 (conducting third-party research on a fee basis for non-affiliated entities) to now qualify for the MIC by virtue of a unitary relationship with a manufacturing entity.

The expanded definition of property used in research and development appears to conflict with the definition of "research and development" at R&TC § 17053.49(e)(9) and R&TC § 23649(e)(9), that in turn refer to the IRC, and describes activities that are generally not considered research and development under those definitions.

The determination of direct costs of labor, including payments to third party vendors, has been determined by the department in administering the MIC by reference to federal rules identifying "capital costs." These rules are popularly known as the "UNICAP" rules and are used to distinguish between direct and indirect labor costs for the MIC. These rules support the narrow exception to the general MIC concept that qualified costs are amounts upon which California sales or use tax is paid. Expanding the definition of "qualified costs" to include indirect costs would result in a revenue decrease, but would also reduce an area of conflict with taxpayers, especially with respect to substantiating costs paid to independent (i.e., third party) contractors.

This bill would create the only current credit that would be allowed to reduce the alternative minimum tax for corporations. The result would be an advantage to corporate taxpayers as compared to individual taxpayers. The philosophy of the AMT is that all taxpayers should pay at least some minimum tax if they are benefiting from tax preferences. An exception to that policy may not be desirable.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 240
As amended April 17, 2001

AMENDMENT 1

On page 8, line 2, strike out ~~1245(A)~~ and insert:

1245(a)

AMENDMENT 2

On page 11, modify lines 33 and 34 as follows:

on or after January 1, 1994, ~~and prior to the date this section ceases to be operative under paragraph (2) of subdivision (i)~~, shall be

AMENDMENT 3

On page 23, line 2, strike out ~~1245(A)~~ and insert:

1245(a)

AMENDMENT 4

On page 26, modify lines 33 and 34 as follows:

on or after January 1, 1994, ~~and prior to the date this section ceases to be operative under paragraph (2) of subdivision (i)~~, shall be